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Dear Sir or Madam:

I would like to take this occasion to offer some comments on the current version of UCITA that is now up for approval before the House of Delegates of the American Bar Association. As is doubtless the case universally, I have points of difference with the proposed model act. But in the grand scheme of things, these pale into insignificance, because by and large the basic pro-contractual orientation of UCITA is sound and merits your support. I have dealt with many of the issues raised under UCITA in an earlier report on this subject that I prepared on behalf of Digital Commerce Coalition (DCC) to the FTC, written in response to its request for information (High Tech Project 994413, dated September 11, 2000). The views I express on this occasion are solely my own, and not necessarily those of any organization or firm, including the DCC or its member firms. I have received no compensation for writing this letter from any source.

The central question for UCITA is whether the principle of freedom of contract that has worked so well with the Uniform Commercial Code should carry over to the law governing digital technology under UCITA. As noted in the Report of the National Commissioners on Uniform State Laws (NCCUSL), many of the knotty problems that arose under the UCC concerned the uneasy fit of computer software within the class of goods. But even after the appropriate adjustments are made, the basic philosophy of freedom of contract that animates the UCC can be successfully carried over to UCITA.

In particular, it is proper to treat most of the provisions in UCITA as default provisions, which the parties should be able to vary at will. The preference for freedom of contract is not a covert device to favor software producers over the full range of software customers, which includes just about everyone from sophisticated hi-tech users to ordinary consumers. For the former, there seems to be no reason why the usual principle of freedom of

contract does not apply. But even for ordinary consumers, the case for the freedom of contract regime is compelling. To be sure, once a loss has occurred the interests of any particular customer will be adverse to the interests of his software vendor. But the right time to measure conflict of interest is at the outset of these transactions. The relevant interests, moreover, are not solely those customers who end up with grievances against some software supplier. It is the full set of customers, including those whose transactions have gone through without a hitch. In making this global assessment, moreover, it is critical to look at the full array of customers with its wide variation in sophistication, experience, and, yes, honesty in transactions. From this ex ante perspective, all customers should recognize that one objective of a software vendor is to protect honest and competent customers against other users who would take advantage of whatever opportunities are presented to them, even if it means the commission of a fraud or an unfair practice against the firm. The costs that these wayward customers create may be imposed initially on the software seller, but they are ultimately funded by all customers as part of their initial purchase price. Unless steps are taken to guard against the untoward behavior of a few, honest and competent customers will have to pay for the errors and misconduct of less scrupulous or able customers. The higher initial prices will retard the penetration of new products into the market, and increase the overall level of deadweight social loss. The software vendor who provides protection against these abuses acts as the de facto agent of all its reputable customers.

The key question therefore is whether the incentives of honest and competent customers and producers are aligned in the ex ante position. There is no reason to think that they are not. The entire industry is highly competitive. It contains a large number of repeat players who are familiar with the usual contractual limitations associated with the use and sale of software devices. Even naïve consumers typically have friends, technical support staff or teenage children who can help them navigate particular transactions. The level of background knowledge is high, and the access to new information is great. There is no reason why a robust regime of freedom of contract will not work well in this area. The stress that UCITA places on default rules is correct under the circumstances.

Of special concern in this connection are several specific contractual provisions. The first of these has to do with the question of when and how contracts are completed. In my view one of the least successful innovations of the original UCC was section 2-207 which displaced the older common law rule that held acceptance of goods with knowledge of the terms on which they were shipped was tantamount to the acceptance of those contractual provisions, including arbitration clauses on the one hand and limitations on consequential damages on the other. UCITA focuses its attention solely on cases involving the

battle of order and invoice forms. I think that the common law approach makes sense. Clickwrap and shrinkwrap provisions are easy to announce and their acceptance is easy to verify. There is no reason to adopt special rules that make the incorporation of these terms into the contract a matter of doubt, subject to case by case adjudication that is both costly and unreliable. Those costs are borne by the vendor in the first instance, but in the long run they are passed on to customers as a class. Ex ante the vendor has the correct incentives to include all those provisions, and only those provisions, that are worth more to customers as a group than they cost to the firm. There is accordingly no risk of exploitation. Indeed, even if there were (as there most definitely is not) a monopoly problem, the right response comes from the antitrust laws, not from the creation of some special rule of offer and acceptance that makes no sense in competitive markets.

This point is clearly illustrated by reference to the common clauses that exclude recovery for consequential damages by limiting purchasers to repair or replacement of defective (i.e. unmerchantable) products. The economic logic behind these clauses is unexceptionable. After the fact, full consequential damages may make the buyer indifferent between breach and performance by the seller. But by the same token that rule creates two risks that are borne by all buyers as a class. First, it forces the seller to charge high prices to all its customers, no matter what the individual level of risk of potential associated with their particular use. This is tantamount to a regime that charges a flat rate for insurance even though the risk of a major merchant with large data bases is far larger than that for the casual home user. The effect of a uniform rate could well be to force low risk customers, especially ordinary consumers, out of the market. The rule that allows full recovery of consequential damages must be paired with a second rule that requires the innocent purchaser to mitigate losses once the defect is discovered. Yet that rule is expensive to apply because it requires a software seller at a distance to monitor on a case by case basis the loss avoidance activities of each individual buyer. In contrast, the fixed limitation on damages provides strong incentives for the buyer to mitigate losses while eliminating all the administrative and monitoring costs associated with the consequential damages rule. The prudent buyer will, for example, mitigate losses by making backups, having reserve power sources, or by adopting other loss avoidance techniques. A contractual limitation (allowed in UCITA as in the UCC and the common law) on consequential damages puts all buyers on an equal footing, making pricing more accurate and damage mitigation more secure.

The logic behind arbitration clauses (whose status is not altered by UCITA) is similar. Litigation is expensive, and it often works like a lottery in its outcome. The huge awards to a tiny group of lucky plaintiffs have to be funded out of revenues derived from every purchaser in order for the market to be

viable. The litigation costs are also higher given the high stakes in the underlying dispute. In addition, lay juries could easily be misled about the merits of complex technical disputes. Arbitration is often desired because it addresses each of these three failings of the overall legal system. And in those cases where it does not function well, it need not be adopted at all. Yet once again the software seller has all the right incentives to provide remedies ex post that will be strong enough for customers as a class to purchase their products.

In sum, there are no obvious sources of market failure here, UCITA avoids the dangers of mandated terms in dynamic markets. The legislation has been in effect in two states without any evidence of economic dislocation. The great advances in software are evident in price, speed, versatility and reliability. All that progress has taken place under common law and UCC rules similar to those articulated and refined in UCITA. This is not the time to upset the applecart. The proposed model Act is worthy of ABA approval, for customers as well as vendors.

Sincerely yours,

Richard A. Epstein